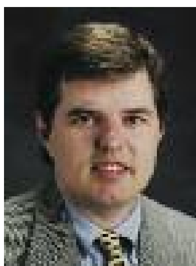
Less Appreciated Aspects of Indexing vs. Active Management

by Mark W. Riepe, CFA



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A perennial question is whether to use index or active mutual funds. It's an important question—even more now that exchange-traded funds offer large and small investors alike the opportunity to index virtually all corners of the capital markets.

Unfortunately, the debate is often framed in terms of simple performance comparisons between active funds as a group and a comparable index. Statistics like the percentage of active funds an index fund beats in a given year are instructive, but the decision between the two is more complex than is conveyed by such a number.

What follows are some opinions as to aspects of the debate that don't get enough attention.

Preferences

Everybody likes to outperform, and mutual funds that outperform their peers are lauded for their success. In some studies of index vs. active, performance is treated as a binary variable (that is, the benchmark was beaten or it wasn't). I think many clients have a more textured view of performance. In this world, magnitudes of relative performance matter. For example, some want to hit home runs instead of singles and want their fund to show up on a "Top 10 Performing Funds of 2009" list. Index funds tend to be above-average performers over long periods, but will rarely be at the very top of the performance charts over shorter periods.

Of course, not every client is looking for home runs. To extend the baseball analogy, some hate the idea of striking out and will gladly shorten their swing to avoid it. If index funds don't often hit the top 10 list on the upside, they rarely hit the bottom depths of the performance charts either.

The practical implication of this aspect of investor psychology is that an assessment of the client's risk tolerance shouldn't just be used for setting the strategic asset allocation. A deeper analysis (for example, "Do you want to swing for the fences or are you content with trying to hit for a higher percentage?") is useful to determine what kinds of funds to use to gain exposure to a particular asset class.

Price

"Price" refers to the management fees charged by active funds. A knock against active management is that it is doomed to fail. Let's divide the world into active funds and indexers and assume that indexers track the market exactly. If this is the case then active investors must, as a group, have a return equal to indexers on a gross-of-fees basis. On a net basis, active funds will trail.

As formulated, that is undoubtedly true. However, not all active investors are created equal. In all human endeavors, the level of skill brought to bear on a problem by participants varies. I see no reason to think that money management is any different.

One might expect that the price that is charged fund shareholders would reflect their skill level. Higher quality funds would charge more than lower quality funds, leading to an alpha (net-of-fees) equal to zero for all active funds.

The real world doesn't seem to shake out that way. Perhaps because of shareholders not paying enough attention or the difficulty of identifying true money management skill, there isn't as tight a correlation between alpha generation and the level of management fees. As a result I suggest that advisers be more careful about calculating the alpha-generating potential of the active funds they are considering using and explicitly compare that alpha potential against the fees being charged. Given that

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I'm in the camp that alpha is tough to find in most markets, a fund selection methodology that emphasizes low-cost funds is more likely to succeed.

Process

If we accept that there are individuals who prefer the return pattern of active funds and that at least some actively managed funds are capable of outperforming their benchmarks, the next question is whether it's possible to identify the good funds of tomorrow.

It is on this point that I think many people get wedded to some other statistics that get routinely thrown out. For example, let's assume that in most categories of funds, an index fund representative of that category frequently outperforms the average active fund in the category. Does that mean active funds should never be used? Most advisers who use active funds aren't trying to pick average funds. They're going after top quartile funds of the future that aren't taking inordinate amounts of risk to achieve that top quartile performance.

Viewed this way, the proper question isn't how index funds perform when compared to average funds, but where in the distribution of fund returns does one expect an index to reside? Once that estimate is made, does one have a process to identify the active funds that can breach that threshold?

In some categories of funds that bar will be tougher (easier) to beat, thus creating a higher (lower) standard that an adviser's process must meet.

Further compounding the difficulty is that index relative to active performance will vary depending on market conditions. For example, in the bond market, active funds appear to systematically underweight Treasuries relative to their benchmark indexes. In Treasury-led markets such as 2008, that makes index funds tough competitors. On the equity side, actively managed funds tend to hold smaller companies relative to their benchmarks, causing the percentage of active funds outperforming to be a function of the small-cap risk premium. We've also observed that the active funds tend to do worse during momentum driven markets.

Bottom Line

The world of investing can easily accommodate both actively managed and index funds. That creates, however, a burden for the adviser to be thoughtful in deciding if and when to use one or the other or both.

When it becomes time for you to make that decision, be thoughtful about the many nuances of the decision.

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